No. 11,941

In the United States Court of Appeals for the Ninth Circuit

HARRY V. SOANES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

FRANK O. BELL, PETITIONER

v.

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LUTHER E. GIBSON, PETITIONER

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VALLEJO BUS COMPANY (A DISSOLVED CALIFORNIA CORPORATION), PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

THERON LAMAR CAUDLE,
Assistant Attorney General.
GEORGE A. STINSON,
ELLIS N. SLACK,
I. HENRY KUTZ,
Special Assistants to the Attorney General.

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OPINION BELOW

The only previous opinion (R. 50-58) is the opinion of the Tax Court which is reported in 10 T. C. 131.

JURISDICTION

The petitions for review involve federal declared value excess profits tax and excess profits tax for the year 1942. (R. 61-63.) On March 5, 1946, the Commissioner of Internal Revenue mailed to taxpayers notice of deficiency of declared value excess profits tax liability in the amount of $3,074.94, and of excess profits tax in the amount of $27,721.76, both for the year ended December 31, 1942. (R. 3, 7-13, 50.) Within ninety days thereafter, and on May 27, 1946, taxpayers filed petitions with the Tax Court for redetermination of the deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 3-6, 49-50.) The final orders and decisions of the Tax Court, determining that there is a deficiency on the part of taxpayer. Vallejo Bus Company, and liability on the part of the three individual taxpayers, as transferees of the assets of taxpayer, Vallejo Bus Company, for declared value excess profits tax and excess profits tax for the year 1942 in the respective amounts of $3,074.94 and $27,721.76, were entered on January 27, 1948. (R. 58-61.) The cases are brought to this Court by petitions for review filed April 26, 1948 (R. 61-64), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948. By order of this Court and stipulation all four petitions for review are consolidated for briefing, argument, hearing and decision, and only the papers filed on behalf of taxpayer, Vallejo Bus Company, and the decisions of the Tax Court in all four cases are printed. (R. 70-71, 74-75.)

QUESTION PRESENTED

Whether the income derived from the operation of certain bus lines for the period June 1, 1942, to September 15, 1942, is taxable to taxpayer, Vallejo Bus Com-

pany, and to the individual taxpayers as transferees of the assets of taxpayer, Vallejo Bus Company.

STATUTES INVOLVED

The statutes involved are set out in the Appendix, *infra.*

STATEMENT

Based upon a stipulation and exhibits (R. 50), the Tax Court made the following fact findings:

Taxpayer, Vallejo Bus Company, a California corporation with principal office at Vallejo, California (hereinafter usually designated as taxpayer corporation), was engaged in the operation of bus lines in the vicinity of Vallejo, and reported income from such operations for the period January 1 to May 31, 1942. (R. 50.) As a public utility, taxpayer corporation was subject to the Railroad Commission of the State of California. (R. 51.)

The three individual taxpayers, all residents of Vallejo, were shareholders of the corporation. Taxpayer Soanes owned 50% of its capital stock, taxpayers Gibson and Bell, 25% each. These three individuals decided to operate the business as a partnership and made an oral agreement on May 19, 1942, to acquire and operate the bus lines under the firm name of Vallejo Bus Company. Each individual taxpayer, pursuant to the agreement, was to have an interest in the partnership proportionate to his shareholdings in the corporation. The oral partnership agreement was reduced to writing and signed by the parties on November 12, 1942. (R. 50-51.)

On May 19, 1942, the partnership made an offer to taxpayer corporation to purchase its operative rights and all of its assets except four Reo buses, for the sum of $29,937.20 cash. The taxpayer corporation accepted the offer on that day and in its corporate minutes re-

cited that the offer of sale and acceptance was (R. 51)—

> * * * to become effective on the first day of June, 1942, subject to the approval of said transfer by the Railroad Commission of the State of California.

The contract of sale between taxpayer corporation and the partnership was reduced to writing and signed by the parties on June 9, 1942. (R. 51-52.) It contained the following (R. 52):

> It Is Understood and Agreed that the sale of said personal property herein above described shall be effective as of June 1, 1942, but that same is subject to the approval of the Railroad Commission of the State of California and in the event said approval is not forthcoming, this agreement will be null and void and of no effect, and the parties hereto shall be and remain in the same relationship and in the same situation that they are in prior to the execution of this agreement, and shall occupy the identical positions and relationships that they would have occupied had this agreement not existed.
>
> Upon receiving the approval of the Railroad Commission of the State of California to said sale, the parties hereto and each of them agree to execute and deliver any and all instruments and documents necessary or convenient to carry into being the full intent and purpose of this agreement, * * *.

On the same day, June 9, 1942, taxpayer corporation as seller and the individual partners as buyers filed a petition with the Railroad Commission of the State of California, requesting the Commission to approve the sale and transfer of its assets and operative rights to the partnership. On September 15, 1942, the Commission issued its order, granting and approving the petition and further requiring that the partnership within sixty days file an appropriate time schedule and

a withdrawal and adoption notice of tariffs, as required by the Commission's regulations, and further to file within thirty days a copy of the partnership agreement. (R. 52-53.)

Taxpayer corporation was dissolved on December 31, 1942. The partnership opened a bank account on June 1, 1942, in the name of Vallejo Bus Company, a partnership, and all receipts and revenues from the operation of the business on and after that date were deposited in this bank account. (R. 53.)

Effective on or before June 11, 1942, the beneficiaries in all policies of insurance were changed from taxpayer corporation to "Luther E. Gibson, Harry V. Soanes and Frank O. Bell, doing business as Vallejo Bus Co." The record legal title of automobiles owned by taxpayer corporation was not changed to the partnership until 1943. (R. 53.) The partnership filed a partnership return for 1942 reporting income from the operation of the bus lines for the period June 1 to December 31, 1942. (R. 50.)

The Commissioner ruled that the transfer from taxpayer corporation to the partnership was not effective until the Railroad Commission authorized the transfer in its order dated September 15, 1942, and earnings from the bus line operations to September 15, 1942, should have been included in the income of taxpayer corporation. Hence, the Commissioner determined that the income reported by taxpayer corporation should be increased in the amount of the business earnings between June 1 and September 15, 1942, resulting in the deficiencies in declared value excess profits tax and excess profits tax for the year 1942 here in question. (R. 9-10.) The Commissioner was affirmed upon review by the Tax Court (R. 53-58), and its petition for review here is from the adverse Tax Court decision (R. 61-63).

The Commissioner also determined liability in the individual taxpayers Soanes, Bell and Gibson, for the deficiencies found against taxpayer corporation, as transferees of taxpayer corporation's assets. In the Tax Court, where the proceedings against taxpayer corporation and the three individual taxpayers were consolidated for hearing and decision, the individual taxpayers conceded liability for any deficiency due, but contended that the Commissioner erroneously included in taxpayer corporation's 1942 income the profits of the partnership for the period June 1 to September 15, 1942.[1] (R. 50.)

Similarly, in this Court the individual taxpayers by stipulation (R. 74-75) approved by an order of this Court (R. 70-71) conceded that they are the transferees of taxpayer corporation, that, as such, they are liable for its tax deficiencies for the year 1942 (together with interest), as may here be determined, and that the decisions in the cases of the individual taxpayers are to be governed by the decision of this Court in the case of taxpayer corporation inasmuch as the liability asserted against them is the liability of taxpayer corporation. This order and stipulation further

---

[1] Thus, before the Tax Court the parties stipulated (R. 19-20):

> If the Court determines that the income from the operation of said bus lines for the period June 1, 1942, to September 15, 1942, was correctly reported by said partnership, then there is no deficiency in Petitioner's income tax or declared value excess profits tax for the calender year 1942, and the deficiency in Petitioner's excess profits tax for the calendar year 1942 is the sum of $344.26. If the Court determines that the income from the operation of said bus lines from the period June 1, 1942, to September 15, 1942, is taxable to Petitioner, then the deficiencies to be determined by the Court as follows: Declared value excess profits tax deficiency of $3,074.94, and excess profits tax deficiency of $27,721.76. It is stipulated that Luther E. Gibson, Docket No. 11045, Frank O. Bell, Docket No. 11044, and Harry V. Soanes, Docket No. 11043, are transferees of Petitioner herein and as such are liable for such deficiencies as may be determined in this proceeding, together with intrest thereon as provided by law.

provide that the four cases be consolidated for briefing, argument, hearing and decision, and that only the papers filed on behalf of taxpayer corporation and the decisions of the Tax Court in the cases of the individual taxpayers be printed as the transcript of record on the four petitions here for review.

SUMMARY OF ARGUMENT

The record sustains the factual conclusion of the Tax Court that under their agreement the parties intended the bus line properties and franchises to remain the property of taxpayer corporation until their proposed sale to the partnership obtained the approval of the California Railroad Commission. Certainly this construction by the trier of the facts of the intention of the parties may not be claimed to be clearly erroneous. Indeed, the record shows that in making this factual finding the Tax Court was only taking the parties at their own sworn word. This appears from the construction which they themselves placed upon the transaction in their application to the Railroad Commission for authorization to transfer the properties and the public operating rights involved. Had the parties understood the agreement to constitute a consummated sale and purchase it would have been simple enough for them to have said so in their application to the Commission. On the contrary, the language, which they actually did use, explicitly establishes that they intended and construed the agreement to be executory and not a completed transaction. The Commission's order of September 15, 1942, granting their application further supports the Tax Court's conclusion that the transfer of the properties had not in fact occurred on any prior date. The intrinsic terms of the contract to sell make plainly apparent the correctness of the constructions by the parties and the Commission. These

establish the intent for an executory transaction and not a completed transfer.

In any event, by force of California law, consummation of the transfer was inhibited prior to receipt of authorization by the Railroad Commission. If the agreement of June 9, 1942, or any other acts by taxpayer corporation had actually contemplated a completed transfer of any part of taxpayer corporation's properties or franchises, clear violation of California statutory provisions would have been entailed and liability for criminal and civil penalties incurred. Hence, upon well settled principles a consummated transaction such as taxpayers here assert would have been unenforcible and void for illegality. The California authorities have repeatedly held that a purported transfer before approval by the Railroad Commission in violation of the controlling statutory provisions confers no rights on the transferee and is completely ineffectual.

Taxpayers' additional argument that the disputed income cannot be taxed to taxpayer corporation but must be taxed to the partners because allegedly received after June 1, 1942, by the partnership under a claim of right, is without foundation in the record. As found by the Tax Court, the record establishes that the possession, if any, by the partnership of the receipts in question during the disputed period was held by the partners as agents for taxpayer corporation which remained their lawful owner until September 15, 1942. A correct construction of the contract as well as the force of California law requires this result. Moreover, the claim of right theory, as here asserted, is inherently fallacious and completely begs the question. If the taxpayer corporation was righly entitled, as the Commissioner contends, to the earnings during the period between June 1, and September 15, 1942, the circumstance that some other persons might wrongly claim them and that tax-

payer might in addition accede to this incorrect claim does not excuse taxpayer from liability for the tax. Such a novel doctrine would place the Treasury at the mercy of parties arranging between themselves as to which should claim the right to receipts and bear the burden of the tax. Taxpayer corporation is liable for the tax because the income belonged to it as and when earned.

ARGUMENT

The Tax Court properly held the profits derived from the operation of the bus line properties and franchises between June 1, 1942, and September 15, 1942, returnable by taxpayer corporation and not by the partnership

The owner of the income in question, when and as earned, is properly liable for the tax. The source of this income was the bus line properties, namely, the eighteen buses, transportation equipment including coin boxes, machinery, tools, materials, supplies, furniture and business fixtures, and in particular the public franchise and operating rights. (R. 26-27.) It follows that so long as these properties continued in the ownership of taxpayer corporation the income which they earned likewise belonged to and were taxable to it. Hence, as the Tax Court recognized, the principal question in issue is the date when the sale and transfer of these properties from taxpayer corporation to the partnership was consummated. (R. 53.)

We contend that the Tax Court (1) properly construed the intent of the parties to be that the properties were not transferred until after approval by the California Railroad Commission was obtained; and (2) properly held that, in any event, under the law of California, taxpayer corporation was unable to sell, assign, or otherwise dispose of, the whole or any part of these properties necessary and useful in the performance of its public duties or any of its franchises without first having secured an order from the Railroad Commission

authorizing it so to do. Accordingly, until this authority was obtained by the Railroad Commission's order of September 15, 1942, both under the parties' agreement as well as by force of California law, the properties in question, including the operating rights, continued to belong to taxpayer corporation and the profits which they earned continued to be its gain and its tax responsibility.

A. *The record sustains the factual conclusion of the Tax Court that under their agreement the parties intended the bus line properties and franchises to remain the property of taxpayer corporation until their proposed sale to the partnership obtained the approval of the Railroad Commission*

The Tax Court concluded that (R. 54)—

> The order of the Commission authorizing the sale was not obtained until September 15, 1942, and transactions prior thereto would appear to be executory and lacking in finality.

Further, "under the facts" (R. 57), the Tax Court held (R. 57-58)—

> that the possession, if any, by the partnership, of the bus line, its properties or profits during the period in question, was held by the partnership as agent of petitioner corporation which remained the lawful owner of same until September 15, 1942.

Explicitly referring to the quoted provisions (see Statement, *supra*) of the corporate resolution authorizing the sale "subject to the approval of the Railroad Commission" and of the contract of sale dated June 9, 1942, further prescribing that "in the event said approval is not forthcoming this agreement will be null and void

and of no effect" (R. 56), the Tax Court held that (R. 56-57)—

> the sale could not be completed * * * under * * * the contract of the parties until approval by the Railroad Commission was had, and profits earned prior thereto in the bus lines operation belonged to petitioner corporation and is taxable to it.

This construction by the trier of the facts of the intention of the parties is amply sustained by the record. Certainly, it may not be claimed to be clearly erroneous. Section 36 of Act of June 25, 1948, Public Law 773, 80th Cong., 2d Sess.; Rule 52 (a), Rules of Civil Procedure. The record shows that in making this factual finding the Tax Court was only taking the parties at their sworn word. This appears from the construction placed upon the agreement by the very parties to it under oath in their application to the Railroad Commission for authorization to transfer the properties and public operating rights involved. (R. 28-32.) Thus, in the petition supporting this application, which was signed by taxpayer corporation and by the partnership (R. 31), and sworn to by its officers and by the partners as true (R. 31-32), it is unconditionally stated (R. 29)—

> That applicant Vallejo Bus Company, a corporation, is *at the present time* engaged in the operation of an automotive service for the transportation of passengers * * *. (Italics supplied.)

The petition was dated and verified June 9, 1942 (R. 31-32), the same day as the agreement to sell (R. 26). Moreover, in this petition they explicitly construed the agreement in question as constituting not a present sale, but a contract to sell. They annexed a copy of the agreement to the petition and stated that they had "heretofore entered into" it and that "under * * * [this] agreement" (R. 30)—

> The Applicant, Vallejo Bus Company, a corporation, *proposes to sell,* and Applicant Luther E. Gibson, Harry V. Soanes and Frank O. Bell, copartners * * * *propose to purchase* * * *. (Italics supplied.)

Had the parties understood the agreement to constitute a consummated sale and purchase, it would have been simple enough for them to have said so; the fact is that the language which they actually did use explicitly establishes that they intended and understood the agreement to be executed *in futuro* and, as found by the Tax Court, to intend an executory and not a completed transaction. If possible, this is made even plainer from the further language of the petition that (R. 30)—

> The consideration *to be paid* for the property herein *proposed to be transferred,* is the sum of $29,937.20 of which the sum of $28,437.20 represents the value of the equipment, and $1500.00 represents the value of the operative rights. (Italics supplied.)

Finally, the relief requested is not that the Railroad Commission *ratify* a transfer already completed, but for an "order authorizing the transfer". (R. 31.) Thus, the taxpayers' own sworn statement conclusively refute their argument on this appeal that they intended a completed transfer on June 1. (Br. 20-24.)

The Commission's order of September 15, 1942, granting this application, further supports the Tax Court's conclusion that the transfer of these properties had not in fact occurred on any prior date. This was no *ex parte pro forma* proceeding, but entailed "a public hearing" before an examiner and the submission of testimony. (R. 33.) The application was not granted unconditionally, but subject to conditions which the Commission expressed in its order. Thus, a valuation limitation, important for future rate fixing purposes, was

placed upon the operative rights, and the transferee partnership was required to file time schedule and adoption notice of tariffs upon notice to the Commissioner and the public. (R. 33-34.) Again, the permission was not expressed as a ratification of a past and completed transfer but was an authorization "to transfer, *on or before December 31, 1942* * * * the properties described in the agreement on file in this proceeding, together with the operative rights" (italics supplied) (R. 33), and the order expressly became effective only upon its date (R. 34). Similarly, the partners were required to file a copy of their partnership agreement "within thirty (30) days *after they acquire* the aforesaid properties" (italics supplied) (R. 34), thus clearly contemplating that these properties had not theretofore been the property of the partnership. As a matter of fact, no written partnership agreement actually was then in existence and none was drawn until November 12, 1942 (R. 16), filed with the Commission November 13, 1942 (R. 18), thus, again evidencing the parties' own understanding of the tentative character of the partnership arrangement prior to the Commission's approval of the transfer.

Turning to the agreement itself, consideration of its terms makes plainly apparent the correctness of these several constructions discussed immediately above all to the effect that the transfer was not intended to be consummated until after the approval by the Commission. (R. 26-28.) The contract is not in form a present sale nor bill of sale or transfer. On the contrary (R. 26)—

> Seller agrees to sell unto said Buyers and said Buyers agree to buy of and from said Seller * * *.

Indeed, expressly execution and delivery of instruments of transfer were conditioned upon receipt of approval

by the Commission. Thus, the agreement further provided (R. 27)—

> Upon receiving the approval of the Railroad Commission of the State of California to said sale, the parties hereto and each of them agree to execute and deliver any and all instruments and documents necessary or convenient to carry into being the full intent and purpose of this agreement, * * *.

This was also the practical construction eventually followed by the parties in carrying out this agreement, for, as stipulated (R. 17)—

> 6. Record legal title of automobiles as evidenced by ownership certificates were not surrendered to the State authorities for transfer from Vallejo Bus Company to Vallejo Bus Co., and it was not until new ownership certificates were issued in the succeeding year that the record legal title was thus transferred.

The agreement not only left open important provisions for future execution, but actually left open a facet of the transaction for future negotiation, to be entered into only upon receipt of approval by the Railroad Commission. Thus (R. 27-28):

> Upon receiving the approval of the Railroad Commission of the State of California to said sale, * * * and at such time the parties hereto shall negotiate a lease in terms agreeable to both parties, wherein and whereby said Seller shall lease unto said Buyers the following described Reo busses of the said Seller: * * *.

The buses described are four in number (as contrasted with the eighteen which taxpayer corporation agreed to sell (R. 26)), and by inference apparently constituted part of its newest transit equipment (R. 38).

Similarly, under the language already referred to,

repeated here for convenience, the agreement sets forth (R. 27):

> It is Understood and Agreed that the sale of said personal property herein above described shall be effective as of June 1, 1942, but that same is subject to the approval of the Railroad Commission of the State of California and in the event said approval is not forthcoming, this agreement will be null and void and of no effect, and the parties hereto shall be and remain in the same relationship and in the same situation that they are in prior to the execution of this agreement, and shall occupy the identical positions and relationships that they would have occupied had this agreement not existed.

These terms on their face as well as when read together with the remaining promises and conditions contained in the contract and with the parties' own construction of them discussed, *supra,* surely further express the intention for an executory transaction, lacking in finality. The sale was subject to the approval of the Railroad Commission and in the event this approval was not forthcoming the agreement was of no effect. Only in the event of such approval, as part consideration from the corporation to the partners, the intent of the contract may have been to transfer to the partnership the earnings of the personal property and operating rights retroactively "effective as of June 1, 1942". (R. 27.) These properties and their earnings, as and when earned, continued to belong to taxpayer corporation and were not intended to be transferred until authorized by the Commission. See *Lucas* v. *North Texas Co.,* 281 U. S. 11; *Michigan Steel Corp. of New Jersey* v. *Commissioner,* 38 B.T.A. 435, 452; L. O. 1082, I-1 Cum. Bull. 80 (1922); *O'Brien* v. *Commissioner,* decided January 15, 1945 (1945 P.-H. T. C. Memorandum Decisions, par. 45,069); *Wass and Stinson Canning Co.* v.

Commissioner, decided November 30, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,350). Upon well settled principles, the owner of a business cannot by contract escape the tax upon its earnings and, thus, the income here remained taxable to taxpayer corporation, even if the agreement is considered to amount to an anticipatory assignment payable, after receipt of the State Commission's approval, to the partnership of this income belonging to taxpayer corporation and earned by properties and operating rights belonging to it during the critical period. *Lucas* v. *Earl,* 281 U.S. 111; *Corliss* v. *Bowers,* 281 U.S. 376; *Helvering* v. *Horst,* 311 U.S. 112; *Helvering* v. *Eubank,* 311 U.S. 122; *Harrison* v. *Schaffner,* 312 U.S. 579; *Commissioner* v. *Sumnen,* 333 U.S. 591; *Rouss* v. *Bowers,* 30 F. 2d 628 (C.C.A. 2d), certiorari denied, 279 U.S. 853.

The decision of this Court in *Seattle Renton Lumber Co.* v. *United States,* 135 F. 2d 989, upon which taxpayers here rely (Br. 23-24), is obviously distinguishable from the instant facts, and, indeed, its reasoning supports the Commissioner's contentions. Thus here, the parties entered into a mere contract to sell; there, on the other hand, a deed was executed and delivered conveying real property and a bill of sale of personal property. Moreover, in the cited case there existed no requirement for approval of the contract by a public body which, until obtained here, left, as the parties well understood, the matter executory and completely lacking in finality. This constituted a substantial impediment to present performance as of the time when the contract was made, and contrary to the factual situation in the cited case, the parties here did not intend a present transfer. See *Wass and Stinson Canning Co., supra.*

The condition, which the contract here imposed, was beyond the control of seller or buyers, and if not ful-

filled rendered nugatory the entire transaction. It is not reasonable to imply an intent, even as between themselves, which for an indefinite period subject to a contingency beyond their control would have placed their affairs in so tentative and unsettled a situation. As we have seen, their own contemporaneous construction without more refutes such an implication. Before the property here involved was in a deliverable condition the consent of the Railroad Commission had to be obtained, and by analogy with the rule applied in sales of personal property a presumption exists against an intention of the parties to a present sale. Civil Code of California, Section 1739, Rule 2 (Uniform Sales Act). See, also, *Paulsen* v. *Gilmore,* 160 Wash. 232, 295 Pac. 135.

Taxpayer emphasizes statements contained in an opinion by the State Railroad Commission dated March 23, 1943, and by the Commission's engineer in a report to the effect that the bus lines operated as a partnership after June 1, 1942. (R. 37, 47-48; Br. 17-19.) The Tax Court was clearly entitled to regard these as merely conclusory, not binding on it and without probative value. (R. 56.) The only question involved before the Commission in the cited proceeding was the determination of rates; the partnership was then unquestionably the operating owner, and the issue here involved was not at all relevant, was not litigated before it nor presented to it for decision. The construction, afforded by the parties themselves before the instant controversy arose and in the course of their application for authority to make the transfer from the corporation to the partnership, is certainly to be preferred.

A question of intention, such as is here involved, is peculiarly one of fact for resolution by the trier of the facts in the light of all the evidence presented in a particular case. Even if arguably the record does

contain some evidence favorable to taxpayers' contention, the record is nevertheless replete with evidence sustaining the Tax Court's finding that the parties to this agreement did not intend a transfer before receipt of approval by the Railroad Commission, and no adequate ground is shown for disturbing this finding on appeal.

B. *In any event, under the law of California the transfer could not be consummated until approval by the Railroad Commission had been obtained*

In the preceding subpoint A, the Commissioner has contended that the parties did not intend the transfer to be completed until receipt of authorization by the Railroad Commission. In this subpoint B, the further contention is made that in any event by force of California law consummation of the transfer was inhibited prior to receipt of authorization by the Railroad Commission.

The controlling California statute is Act 6386, 2 Deering's General Laws of California, known as "Public Utilities Act". Concededly, taxpayer corporation was (R. 16)—

> an active operating public utility under the jurisdiction of the Railroad Commission of the State of California, and held a certificate of necessity issued by said Commission dated May 6, 1941.

Specifically, taxpayer corporation was a "passenger stage corporation" as defined by Section 2 1/4 of that Act. Section 50 1/4 of the Public Utilities Act provides (Appendix, *infra*):

> Any right, privilege, franchise or permit held, owned, or obtained by any passenger stage corporation may be sold, assigned, leased, mortgaged, transferred, inherited, or otherwise encumbered as other property, only upon authorization by the Railroad Commission. * * *

Moreover, by Section 50 1/3, violation of the quoted provision is constituted a misdemeanor, punishable by fine not exceeding $500 and imprisonment for a term not to exceed six months or both. (Appendix, *infra.*) Again, Section 51 (a) of the same statute, legislating with respect to public utilities in general, provides as follows (Appendix, *infra*):

> No public utility shall henceforth sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, * * * without first having secured from the railroad commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger or consolidation made other than in accordance with the order of the commission authorizing the same shall be void. * * *

Sections 76 and 77 of this statute (Appendix, *infra*) impose penalties to the amount of $500 upon any public utility violating any provision of the statute and punishment for a misdemeanor by fine not exceeding $1,000 or by imprisonment not exceeding one year or by both upon any officer, agent or employee of any public utility, who violates or fails to comply with any provision of the statute.

Accordingly, it seems plain that if the agreement of June 9, 1942, or any other acts by the parties to that agreement or by taxpayer corporation alone had actually constituted a completed transfer of any part of taxpayer corporation's properties or its franchises and operating rights described in the agreement (R. 26-27), all of which were necessary or useful in performance of its public duties and franchises, before it had first secured the authority of the Railroad Commission, the

cited criminal and penal provisions of the Public Utility Act would have been infringed. A consummated transaction, such as taxpayers here assert, falls within the direct prohibition of the statute and upon well settled principles would have been unenforcible and void for illegality. *Napa Valley E. Co.* v. *Calistoga E. Co.,* 38 Cal. App. 477. See, also, 6 Williston on Contracts (Rev. ed.), Sec. 765; Restatement, Law of Contracts, Sec. 580.

Taxpayers' contention, as stated in their brief, is as follows (p. 13):

> * * * that the sale of June 1, 1942, was valid on that date *as between the parties thereto* since the Railroad Commission had no authority concerning this sale other than its statutory authority to veto the sale if it should be found contrary to the interests of the public.

The plain language of the statute, however, establishes that this contention is without merit. The statute, as has been seen, does not read that the Railroad Commission may ratify or veto a previously consummated sale. On the contrary, Section 50 1/4 expressly prescribes that a franchise held by a passenger stage corporation may be sold "only upon authorization" by the Commission. Again, even more explicitly, Section 51 (a) insists that "No public utility shall henceforth sell, * * * without *first* having secured" (italics supplied) an order from the Commission, authorizing it so to do. Moreover, "Every such sale * * * made other than" in accordance with an order of the Commission authorizing it "shall be *void.*" (Italics supplied.) The California courts have repeatedly ruled that the statute means what it plainly states and that prior to authorization by the Commission, a purported transfer by a public utility is void, and confers no rights upon the purported transferee. In *Crum* v. *Mt. Shasta Power Corp.,* 220

Cal. 295, 309-311, the Supreme Court of California, passing upon the validity of an offer by a public utility to convey its property, where rights *inter sese* of the parties to the attempted transfer were in question, held that the transfer was *"beyond the power"* (italics supplied) of the utility "to make without first securing the consent of the railroad commission." (Pp. 309-310.) In *Slater* v. *Shell Oil Co.,* 39 Cal. App. 2d 535, 546-547, the court held, applying Section 51 of the Public Utilities Act, that an attempted transfer without the prior authorization of the Railroad Commission was "totally ineffectual". (P. 546.) In the cited case, it is noteworthy that as in the instant case one of the parties to the attempted transfer was a closed corporation. The court said (p. 547):

> It is to be noted that this provision declares every transfer without consent of the Railroad Commission is void. That the section means what it plainly states, that a purported transfer in violation of the statute confers no rights on the transferee, and that third persons may raise this defense, is clearly established by the following cases: *Webster Mfg. Co.* v. *Byrnes,* 207 Cal. 630 [280 Pac. 101]; *Crum* v. *Mt. Shasta Power Corp.,* 220 Cal. 295 [30 Pac. (2d) 30]; *Napa Valley E. Co.* v. *Calistoga E. Co.,* 38 Cal. App. 477 [176 Pac. 699].

The cases of *Hanlon* v. *Eshleman,* 169 Cal. 200, and *Otter Tail Power Co.* v. *Clark,* 59 N. D. 320, 229 N. W. 915, relied upon in their brief by taxpayers (pp. 13-17), are clearly distinguishable from the instant case for the reasons stated by the Tax Court in its opinion (R. 54-55). In fact, the opinion in the *Hanlon* case discloses that the court was there considering only an application to the Commission by owners ready to sell and not those who had already sold. Thus, in the *Hanlon* case, *supra,* p. 203, the court said:

> The provision that an owner may not sell without the consent of the commission implies that there must be an owner ready to sell and seeking authority so to do before the commission is called upon to act.

While the legislature may have vested the power to authori e sales of public utilities in the Commission primarily for the benefit of the public, nevertheless, the better to preserve that function for the Commission, it plainly prescribed that a sale without first the Commission's authorization is of no validity whatsoever. The *Hanlon* case held only that it is not the function of the Railroad Commission, but of the courts, to determine the rights of the parties under a contract of sale, where in dispute. On the other hand, the cited case did not in any sense hold that a purported transfer under such a contract possesses any validity lacking the Commission's approval. Indeed, such is the interpretation of the *Hanlon* case taken in a later case, decided by the same court, *Henderson* v. *Oroville-Wyandotte Irr. Dist.,* 213 Cal. 514, 529-531, where it was again held (pp. 529-530):

> No sale of property burdened with a public use is legal, or of any validity whatever, unless the authority to make such sale is first given by the Railroad Commission.

Similarly, the North Dakota case of *Otter Tail Power Co., supra,* does not sustain the taxpayers' contention, but turned on issues of fraud, estoppel, and other questions entirely irrelevant to the instant question. The action was in equity and the ultimate question was whether the trial court had properly exercised its discretion in granting injunctive relief. The North Dakota statute there was similiar to the California statute here involved. Indeed, the court held, in ac-

cordance with the Commissioner's contention here, that (p. 330)—

> while Clark was inhibited from making a sale of the property to the plaintiff and the bill of sale was void, the executory or option agreements were not illegal or invalid and such agreements were not affected by the invalidity of the bill of sale.

The court decided after a consideration of the particular circumstances that the trial court was justified in granting equitable relief, since "While it may be said that both parties are in delicto, it cannot be said that they stand in pari delicto." (P. 333.) Thus, the case turned upon equitable considerations peculiar to its facts and actually represents a holding that a purported bill of sale in violation of the statute was void. This is directly contrary to taxpayers' contention here.

Again, contrary to taxpayers' contention (Br. 17-19), statements contained in the engineer's report and the Railroad Commission's opinion in the subsequent rate fixing proceeding, decided in March, 1943 (R. 35-48), to the effect that the business operated as a partnership after June 1, 1942, afford no material support to taxpayers' interpretation of the California statutes. As already pointed out, the only question before the Commission in the cited proceeding was the fixation of reasonable rates or fares to be charged during future operations after March, 1943, at a time when the partnership was concededly the owner. No question as to the date when the partnership became the owner or of the interpretation of the California statutes and decisions here involved was in issue, litigated, presented for decision, or decided. The statements upon which taxpayers rely were contained in mere recitals of background and may be regarded as inadvertencies completely immaterial to the issue there presented to the Commission for decision.

Finally, in accordance with well settled principles, it is proper here to presume that the parties did not harbor nor express an intent which would entail the commission of crimes and liability for statutory penalties. On the contrary, the assumption is that their intention, expressed in their contract, was for an executory not a completed transaction, a legal intention and not an illegal one.

C. *The claim of right theory has no application to the instant record*

As an additional argument, taxpayers contend in their brief that the income in question cannot be taxed to taxpayer corporation but must be taxed to the partners on the ground that allegedly after June 1, 1942, the income was received by the partnership under a claim of right. (Br. 25-29.) In the first place, as already discussed, the Commissioner controverts the contention that the partnership received the disputed income after June 1, 1942, under a claim of right adverse to taxpayer corporation or that the partners were free from restrictions as to disposition of this income for the period between June 1, 1942, and September 15, 1942. Hence, for these reasons alone, taxpayers' instant contention cannot be supported under the principles of the cases which establish the claim of right doctrine. *North American Oil* v. *Burnet,* 286 U. S. 417; *Commissioner* v. *Wilcox,* 327 U. S. 404. Thus, as discussed in detail under subpoint A, *supra,* the contract to sell was expressly subject to approval of the Railroad Commission and in the event approval was not forthcoming, the agreement was to be null and void and of no effect and the parties to remain in the same relationship and position as prior to its execution. (R. 27.) As also argued under subpoint A, the parties did not intend a present transfer and the

partnership's claim eventually to receive the income for the period in dispute was not, as a matter of fact, based upon claim of ownership in the interim period. Moreover, by force of California law, an attempted transfer before authorization by the Commission had been obtained would have been entirely ineffectual and a claim of right based upon such an attempted transfer might have subjected the claimants to criminal and civil penalties. Thus, it is not lightly to be assumed that the partners made such claim. (See subpoint B, *supra.*) The profits of the interim period must be regarded as additional consideration to become the property of the purchasers when transfer from the corporation was actually consummated and effective. Under these circumstances, certainly it was not clearly erroneous for the Tax Court to find that possession, if any, by the partnership of the profits during the interim period was held by the partnership as agent of the taxpayer corporation, which remained their lawful owner until September 15, 1942. (R. 57-58.)

In any event, advanced as a ground for excusing taxpayer corporation from paying the disputed tax, this contention adds nothing to the previous argument and, indeed, begs the question. If taxpayer corporation was the owner of the earnings of the business between June 1 to September 15, 1942, as the Commissioner contends, it must return them and it is assessible for the income taxes due upon them. The circumstance that some other persons, e.g., the partners, allegedly might incorrectly have claimed this income as their own affords taxpayer corporation no excuse from tax liability; nor could agreement by this taxpayer to such incorrect claim destroy its obligation to the Treasury. An application of the claim of right doctrine, not to a taxpayer who claims the right but with respect to a taxpayer who claims to be without

right surely is novel, as the Tax Court observed (R. 57), and is without precedent, as far as our research discloses. If this doctrine prevailed, the Treasury would be at the mercy of parties who might readily arrange between themselves as to which should claim the right and bear the burden of the tax. For example, in cases of anticipatory assignments of income, usually the assignee claims the right to the income and concedes tax liability. Nevertheless, the assignor has repeatedly been held liable taxwise. *Lucas* v. *Earl, supra; Helvering* v. *Horst, supra; Harrison* v. *Shaffner, supra; Commissioner* v. *Tower,* 327 U. S. 280; *Lusthaus* v. *Commissioner,* 327 U. S. 293. See, also, *Commissioner* v. *Court Holding Co.,* 324 U. S. 331.

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

THERON LAMAR CAUDLE,
Assistant Attorney General.
GEORGE A. STINSON,
ELLIS N. SLACK,
I. HENRY KUTZ,
Special Assistants to the Attorney General.

OCTOBER, 1948.

APPENDIX

Internal Revenue Code:

SEC. 22 [As amended by Sec 1, Public Salary Tax Act of 1939, c. 59, 53 Stat. 574]. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

2 Deering's General Laws of California:

Act 6386. *Public Utilities Act.* * * *

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§ 50 1/4. *Operation of passenger stages: Certificate: Complaints: Fee.*

* * * * * * *

No passenger stage corporation shall hereafter operate or cause to be operated any passenger stage over any public highway in this State without first having obtained from the Railroad Commission a certificate declaring that public convenience and necessity require such operation, * * *. Any right, privilege, franchise or permit held, owned, or obtained by any passenger stage corporation may be sold, assigned, leased, mortgaged, transferred, inherited, or otherwise encumbered as other property, only upon authorization by the Railroad Commission. * * *

* * * * * * *

§ 50 1/3. *Penalties for violations by stage corporations.* Every passenger stage corporation, as defined in this act, who violates any provision of section 50 1/4 of this act, or who aids or abets, or without being present shall have advised or encouraged any person or corporation in the violation of said section, is guilty of a misdemeanor and shall, upon conviction thereof, if a person, be punished by a fine not exceeding five hundred dollars or by imprisonment in a county jail for a term not to exceed six months, or by both such fine and imprisonment; or, if a corporation, shall be punished by a fine not to exceed five hundred dollars. [Added by Stats. 1933, p. 966.]

§ 51. *Selling, leasing, etc., of public utilities: Acquisition of stock of another utility.* (a) No public utility shall henceforth sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, * * * with out first having secured from the railroad commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger or consolidation made other than in accordance with the order of the commission authorizing the same shall be void. * * * Nothing in this subsection contained shall be construed to prevent the sale, lease or other disposition by any public utility of property which is not necessary or useful in the performance of its duties to the public, and any sale of its property by such public utility shall be conclusively presumed to have been of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser of such property in good faith for value.

(b) *Acquisition of stock of another utility.* No public utility shall hereafter purchase or acquire, take or hold, any part of the capital stock of any

other public utility, organized or existing under or by virtue of the laws of this state, without having been first authorized to do so by the commission. Every assignment, transfer, contract or agreement for assignment or transfer of any stock by or through any person or corporation to any corporation or otherwise in violation of any of the provisions of this section shall be void and of no effect, and no such transfer shall be made on the books of any public utility. Nothing herein contained shall be construed to prevent the holding of stock heretofore lawfully acquired. [Amended by Stats. 1927, p. 78.]

§ 76. *Penalty for offenses not otherwise provided.* (a) Any public utility which violates or fails to comply with any provision of the constitution of this state or of this act, or which fails, omits or neglects to obey, observe or comply with any order, decision, decree, rule, direction, demand or requirement or any part or provision thereof, of the commission, in a case in which a penalty has not hereinbefore been provided for such public utility, is subject to a penalty of not less than five hundred dollars nor more than two thousand dollars for each and every offense.

(b) *Every violation a separate offense.* Every violation of the provisions of this act or of any order, decision, decree, rule, direction, demand or requirement of the commission, or any part or portion thereof by any corporation or person is a separate and distinct offense, and in case of a continuing violation each day's continuance thereof shall be and be deemed to be a separate and distinct offense.

(c) *Act of employee deemed act of utility.* In construing and enforcing the provisions of this act relating to penalties, the act, omission or failure of any officer, agent or employee of any public utility, acting within the scope of his official duties or employment, shall in every case be and be deemed

to be the act, omission or failure of such public utility.

§ 77. *Punishment of utility employees.* Every officer, agent or employee of any public utility, who violates or fails to comply with, or who procures, aids or abets any violation by any public utility of any provision of the constitution of this state or of this act, or who fails to obey, observe or comply with any order, decision, rule, direction, demand or requirement or any part or provision thereof, of the commission, or who procures, aids or abets any public utility in its failure to obey, observe and comply with any such order, decision, rule, direction, demand or requirement, or any part or provision thereof in a case in which a penalty has not hereinbefore been provided for such officer, agent or employee, is guilty of a misdemeanor and is punishable by a fine not exceeding one thousand dollars, or by imprisonment in a county jail not exceeding one year, or by both such fine and imprisonment.

APPENDIX B

SECTION 6 OF APPELLANT'S LEASE PROVIDES AS FOLLOWS

SECTION 6. It is further mutually understood and agreed as follows:

(6a) That the lessor may, in writing, waive any breach of the covenants and conditions contained herein, except such as are required by the act, but any such waiver shall extend only to the particular breach so waived, and shall not limit the rights of the lessor with respect to any future breach; nor shall the waiver of a particular cause of forfeiture prevent cancellation of this lease for any other cause, or for the same cause occurring at another time.

(6b) The lessee may, on consent of the Secretary of the Interior first had and obtained, surrender and terminate this lease upon payment of all rents, royalties, and other debts due and payable to the workmen employed by the lessee, and upon a satisfactory show-